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IN THE

Supreme Court of the United States

OCTOBER TERM, 1959

No. 832

I. A. DRESS CO., INC.,

Petitioner,

—v.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

I. A. Dress Co., Inc. prays that a writ of certiorari issue to review the judgment of The United States Court of Appeals for the Second Circuit, entered on January 11, 1960.

Citations to Opinions Below

The opinion of the Tax Court is reported at 32 T. C. 93. The opinion of the Court of Appeals, printed in Appendix B, *infra*, pp. 9a-12a, is reported at 273 F. 2d 543.

Jurisdiction

The judgment of the Court of Appeals was entered on January 11, 1960, and it is printed in Appendix B, *infra*, p. 13a. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254:

Questions Presented

1. Whether, on the record, the Tax Court was required by reason of Section 534 of the Internal Revenue Code of 1954 to rule that the Commissioner had failed to meet the burden of proof to establish that petitioner's accumulated earnings had exceeded the reasonable needs of its business.

2. Whether the Tax Court applied lawful criteria to determine the reasonableness of the business need for which petitioner had accumulated its earnings and profits.

3. Whether the Tax Court was precluded by law from determining the fact of petitioner's intentions solely on the basis of inferences found in the record without consideration of the testimony in the record which was fairly destructive of that finding.

Statutes Involved

The statutory provisions involved are Section 102 of the 1939 Internal Revenue Code; Sections 531-535, incl., Sections 7453, and 7482(a) of the Internal Revenue Code of 1954. They are printed in Appendix A, *infra*, pp. 1a-8a.

Statement

This case involves a determination by the Commissioner that petitioner is liable for a penalty surtax imposed by Section 102 of the 1939 Internal Revenue Code on those corporations which are formed or availed of for the purpose of preventing the imposition of tax on their shareholders by means of the accumulation of earnings and profits in excess of reasonable needs.

While the matter was pending in the Internal Revenue Service, and before the determination had been finally made, Public Law 367 (84th Cong., 1st Sess., Chapter 805, 69 Stat. 689, 690-691) became applicable to make the provisions of Section 534 of the Internal Revenue Code of 1954 retroactively controlling in this controversy. Section 534 of the 1954 Code provides for a shift in the evidentiary rule of burden of proof in the Tax Court, but only with respect to these penalty surtax cases. That shift in the burden of proof from the taxpayer to the Commissioner is controlled by an interchange of documents prior to the issuance of the statutory notice of deficiency.

As he was required by statute, the Commissioner mailed the statutory Section 534 notification, and the taxpayer responded with the required statement of grounds. Thereafter the Commissioner mailed the statutory notice of deficiency in which he stated that he had determined the petitioner to be a corporation availed of for the purpose of preventing the imposition of tax on its shareholder.

Within the prescribed time, petitioner filed a petition in the Tax Court, in which the claim of a shift in burden of proof by reason of the interchange of notification and statement was duly raised (R. 44-47). The Commissioner pleaded alternatively. He alleged that the burden of proof had not shifted because the grounds were inadequate in fact and law, and because the facts alleged in support of the grounds were incomplete. The Commissioner also affirmatively alleged facts on the basis of which he contended that the accumulated earnings were in excess of immediate needs. (R. 57-63).

Petitioner timely filed a reply (R. 64-67) and in due course the matter came up for trial in New York City before Judge Withey. In obedience to Tax Court Rule 31(b), the parties had jointly stipulated the balance sheets, profit

and loss statements, leases, and all background matter. (R. 3) Petitioner's statement had claimed in substance that dividend distributions had not been made because petitioner believed it necessary to accumulate earnings to provide for the purchase of the fee to the building which it was operating under a leasehold, an acquisition which it believed to be imminent; and because, if it failed to acquire that fee, the acquisition of another was absolutely necessary if it were to continue in the real estate business. (The leasehold was petitioner's sole income-producing asset.)

Before opening, petitioner moved the Trial Judge to rule that the burden of proof had shifted to the Commissioner. (R. 4) Judge Withey refused to rule directly on the burden of proof, but he did rule that the law had made no change in the "duty to go forward with the case." (R. 4 and 5) Petitioner was, therefore, forced to open.

The opening remarks of counsel for the Commissioner informed the Trial Judge that the evidence would show that (1) "the petitioner did not have a definite plan to purchase the building," (2) that if it had, "it was not a reasonable need during the taxable year 1949," and (3) the plan was not an immediate need because "the corporation's existence was assured for the next 15 years" and there was no reason to believe . . . another lease would not be granted." (R. 13)

The Commissioner called but one witness, (R. 2) from whose testimony counsel sought only to prove that there was no record of an offer by petitioner to acquire the building (R. 32-38) but, on cross, the same witness produced petitioner's Exhibit 6, (R. 41-42) a letter in which the building owner urged the building managers to negotiate with petitioner for a better price. Thus, the Commissioner had

failed to produce evidence to establish the conclusions as stated in counsel's opening remarks.

The decision of the Tax Court found the statement by petitioner to be inadequate to shift the burden of proof to the Commissioner. The Tax Court agreed, however, that the alleged ground that accumulation of earnings to acquire a building was a valid ground in circumstances similar to those which prevailed here. But, the Tax Court held that the facts alleged in the statement were insufficient to "support the grounds." Earlier, in the opinion, the Tax Court had said that, to be effective, the statement had to contain "sufficient grounds to justify the accumulation . . . together with facts sufficient, if true, to prove the existence of the grounds . . . " Accordingly the Tax Court held the burden of proof to be unchanged.

The Tax Court went on to hold that the earnings and profits had been unreasonably accumulated because petitioner's "intention eventually to purchase the building and land which it held under lease is too uncertain and indefinite a plan to justify the accumulation of its earnings and profits." That ultimate conclusion was based on intermediate findings: (1) That there was no option nor commitment to buy, (2) That the owner was not committed to sell, (3) That there was no certainty that an agreement of purchase and sale would result, and (4) That petitioner had no urgent need in 1949 to buy because there were 15 additional years remaining to the existing leasehold. The Tax Court did find, however, that petitioner had intended to acquire the fee and had hopes of achieving that intention.

On the question of intent, the Tax Court held that petitioner had not proved by a clear preponderance of evidence that the corporation had not been availed of for the purpose of preventing the imposition of tax upon its stockholder.

The Court said, "In fact, the record contains affirmative evidence that the petitioner *was* availed of for such purpose." (Emphasis by the Court.) The affirmative evidence was, however, all inference. The Tax Court made absolutely no reference to the testimony of the stockholder who had testified that the earnings had been accumulated for the sole purpose of financing the purchase. That evidence had withstood cross-examination, and it was fully corroborated by the testimony of a certified public accountant.

The Court of Appeals affirmed. It held it was unnecessary to decide the question of burden of proof because it would have affirmed, regardless. The Court of Appeals said that Congress could not have intended that Section 102 could so easily be evaded, and that, on the evidence, the Tax Court's conclusions on intent were not clearly erroneous. The Court of Appeals did not refer to the evidence established by petitioner on this issue.

REASONS FOR GRANTING THE WRIT

I. Whether, on the record, the Tax Court was required by reason of Section 534 of the Internal Revenue Code of 1954 to rule that the Commissioner had failed to meet the burden of proof to establish that petitioner's accumulated earnings had exceeded the reasonable needs of its business.

It would appear that this question should be reviewed by this Court to prevent the nullification of remedial legislation twice enacted by Congress. The two Courts of Appeals which were asked to review this question have both passed over the issue.[1]

1. Legislative history[2] discloses that in the 1954 recodification of the penalty surtax on undistributed earnings,

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[1] This case and also *Smoot Sand & Gravel Corp.*, —— F.2d —— (No. 7886, 4th Cir. January 11, 1960).

[2] H. R. Rep. No. 1337, 83rd Cong. 2nd Sess. (1954) p. 52:

> "Your committee has received numerous complaints that this provision [Int. Rev. Code of 1939 §102] is prejudicial to small business, that it has been applied in an arbitrary manner in many cases, and that it is a constant threat to expanding business enterprises. Fear of the penalty tax is said to result frequently in distribution of funds needed by the corporation for expansion or other valid purposes.
>
> "Your committee believes it is necessary to retain the penalty tax on unreasonable accumulations as a safeguard against tax avoidance. However, several amendments have been adopted to minimize the threat to corporations accumulating funds for legitimate business purposes and to restrict the application of the provision in the case of small companies.
>
> (1) *Burden of Proof.*—
>
> * * * * *
>
> Moreover, the complaints of taxpayers that the tax is used as a threat by revenue agents to induce settlement on other issues appear to have a connection with the burden of proof which the taxpayer is required to assume. It also appears probable that many small taxpayers may have yielded

Congress intended to enact a substantial change in the law. The need for a drastic change was precipitated by administrative abuses consisting of arbitrary application of the predecessor statute, and the use of the statute as a threat to obtain settlement of tax controversies. The committees also recorded their purpose to eliminate the prejudicial effect of the penalty on small business and also its existence as a threat to expanding business enterprises.

The major reform accomplished in the 1954 Code was in connection with the matter of proof of the existence of an unreasonable accumulation. Section 534 prescribes a change in the burden of proof in Tax Court proceedings. It is a fair inference from the fact that the changed burden of proof rule is applicable only in Tax Court proceedings that the Congressional denunciation included the application of evidentiary rules in the Tax Court as well as administrative practices in the Internal Revenue Service.

Section 534 operates by means of a "notification" by the Commissioner and a reply "statement" of grounds and facts by the taxpayer, both interchanged prior to the issuance of the statutory notice of deficiency. The burden of proof is pertinent only to the issue of the existence of an unreasonable accumulation which, in turn, is determinative, however, of the issue of intent, unless the corporation proves the contrary by a preponderance ("clear preponderance" in the 1939 Code) of the evidence. (Int. Rev. Code of 1939, §102 (c); Int. Rev. Code of 1954, §533(a))

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to a proposed deficiency because of the expense and difficulty of litigating their case under the present rules."

* * * * *

The language of S. Rep. 1622, 83rd Cong. 2nd Sess. (1954) pp. 68 and 70 is practically identical.

The policy adopted by the Internal Revenue Service to meet the statutory changes is to plead alternatively[3] in its answer to the taxpayer's petition: (a) that the burden of proof has not shifted from the taxpayer because the statement submitted by the taxpayer is either insufficiently detailed in its disclosure of facts or inadequate in its claim of grounds, or both, and (b) that if the burden has shifted, the Commissioner will prove, nevertheless, facts (affirmatively alleged) which will be sufficient to carry its burden of proof. The efficacy of Section 534 to attain its expected result to curb such abuse as may exist in a particular controversy, therefore, becomes entirely dependent on the willingness of the Tax Court to give it meaning. The Commissioner's strategy, evidently, is to escape from the provisions.

Policy established by the Tax Court has been not to resolve the question of adequacy of the statement by preliminary motion either on motion calendar[4] or immediately before the trial proper, though severance of a preliminary issue is sanctioned by the Tax Court and by Federal Civil Procedure Rule 42(b). It is evident that no petitioner will

[3] Section of Taxation, ABA, 1959 Rep. p. 32:

"In the cases which have arisen to date involving §534 statements, the Commissioner has, in his answer to the taxpayer's petition in the Tax Court, consistently denied the sufficiency of the grounds and adequacy of the facts set forth in the §534 statement. The Commissioner has also consistently pleaded an affirmative answer."

[4] Section of Taxation, ABA, 1959 Rep. p. 32:

"In those cases where the taxpayer has presented a motion requesting the court to rule on the issue of burden of proof, the court has uniformly denied such motion. Last year the committee discussed with the Honorable J. Edgar Murdock, Chief Judge of the Tax Court, the possibility of instituting a form of pre-trial procedure which would make possible a determination as to burden of proof prior to hearing. The Chief Judge ultimately determined that the court would not change its present procedure of refusing to rule preliminarily on the sufficiency of a §534 statement to shift the burden of proof. Accordingly, the committee proposes certain legislative changes to implement the operation of §534."

risk a default, and, therefore, this petitioner and all other petitioners who have made the preliminary motion have been forced to open the case in the Tax Court proceeding.

However, that Tax Court policy has deprived taxpayers of the valuable right to insist on the elimination of the presumption of correctness as it relates to the Commissioner's determination on the issue of reasonableness of accumulations, and in this respect, the major benefit intended by the statute has been entirely eliminated. Moreover, the policy of forcing trials without consideration for the incidence of the risk of producing evidence would appear to be a violation of Section 7453 of the 1954 Code, which requires the Tax Court to conduct its proceedings in accordance with the rules of evidence which prevail in trials without juries in the District Court for the District of Columbia.

With respect to the issue of the risk of persuasion, the Tax Court trial judge reserves his ruling until final decision, and until that final decision comes down, taxpayers have no inkling of the extent of the evidentiary burden which the Court will ultimately rule was theirs from the beginning. Thus, taxpayers must, of necessity, try their causes on the assumption that they bear the risk of persuasion. As a result, taxpayers, and not the Commissioner, establish the record—a situation plainly in violation of the remedial provisions of the statute and plainly in violation of all rules of evidence which by reason of Section 7453 of the 1954 Code is fully controlling in the Tax Court.

In no recorded case in which the taxpayer has raised and contested the issue of a shift of the burden of proof to the Commissioner does it appear that a taxpayer has been successful. Primarily, that result has come about from a language change which the Tax Court has read into the statute itself. Section 534 places the burden of proof on the Commissioner to the extent of the grounds which were

disclosed in the taxpayer's statement submitted prior to the issuance of the statutory notice of deficiency. The statutory language is that the taxpayer may submit "a statement of grounds (together with facts sufficient to show the basis thereof) on which the taxpayer relies to establish that all or any part of the earnings and profits have not been permitted to accumulate beyond the reasonable needs of the business." The Tax Court reads that language as calling for a statement which "(1) . . . shows grounds which actually are sufficient to justify the accumulation . . . " and, "(2) . . . contains facts which are sufficient, if true, to prove the existence of such grounds".

It is evident that the Tax Court has read the section to shift the burden of proof from the trial to the statement, but not from the taxpayer to the Commissioner. Effectively, however, the taxpayer continues to bear the twin risks of producing evidence and of persuasion. It is evident that this construction neutralizes any potential for substantial benefit for the taxpayer's cause that the statute may possess.

A canon of construction which produces that result would seem to offend the principle which this Court in *Wong Yang Sung* v. *McGrath*, 339 U. S. 33, 41 (1950) said was proper in the interpretation of a statute designed to correct an administrative abuse. This Court said,

> "[I]t would be a disservice to our form of government and to the administrative process itself if the courts should fail, so far as the terms of the Act warrant, to give effect to its remedial purposes, when the evils it was aimed at appear."

The decisive blow, however, to any efficacy in the statute to accomplish its remedial purpose is found in the concept of the effect of the statute developed by the Tax Court. In the first case in which the Tax Court attempted an analysis of the newly-enacted rule, *Pelton Steel Casting*

Co. v. *Commissioner*, 28 T. C. 153 (1957), *aff'd* 251 F. 2d 278 (7th Cir. 1958), *cert. denied* 356 U. S. 958 (1958), the Tax Court held, substantially, that the burden of proof was material only in such cases where the Commissioner relied on the issuance of accumulations to maintain his determination, and because, in any event and in all cases, the critical factor is that of purpose behind the accumulations, the risk of nonpersuasion as it existed under prior law has remained unchanged.

That view of the statute was crystalized in *Young Motor Co., Inc.* v. *Commissioner*, 32 T. C. No. 131 (1959), *on appeal* 1st Cir., in which the Tax Court held,

> "Assuming in its favor that the evidentiary element of business need has not been rebutted by the respondent because of the statement furnished by petitioner . . ., that factor then becomes neutral."

When the Commissioner persuaded the Tax Court to adopt his contention that the best that a taxpayer could expect from the changed burden of proof rule was the neutralization of the issue of excessive accumulations, the Commission succeeded in his ultimate goal—the avoidance of a shift of the risks of the controversy. However, in order to provide that escape for the Commissioner, the Tax Court was forced to make an even more major alteration in the statute; it was forced to excise the only provision which Congress had carried over intact from the 1939 Code. That provision is Section 533(a) which repeats the theory of the prior law that the fundamental criterion for imposition of the penalty is the existence of an excessive accumulation, and which relegates proof of intent to that of evidence to be offered by the corporation only to establish innocence of motive. The Tax Court was forced to ignore the statement made by the Tenth Circuit in *Jones* v. *Koma, Inc.*, 218 F. 2d 530 (1955), that the law had always been

clearly understood to regard the existence of excessive accumulations as the *sine qua non* of the penalty. That understanding is also plainly the basis of Section 535(c)(1) of the 1954 Code which limits the penalty to the precise dollar amount of the annual accumulation which is excessive.

2. The reason given by both Courts of Appeals for the absence of a necessity to reach the question of burden of proof—that they would sustain on the record, regardless of burden of proof—conflicts with the well-established rule of this Court that procedural regularity is an end in and of itself which must be preserved even though there is the probability that the ultimate decision is correct. In this Court's view, due process does not depend on the relative merits of the causes of the litigants.

In particular, however, that reason would seem to be invalid here. First, it ignores the fact that the record was made by the petitioner. Hence, if the issue of burden of proof had been resolved against the Commissioner, the decision would have, of necessity, been against him because of failure to present affirmative proof. Secondly, the Court of Appeals appraised the record on the assumption that the Commissioner's determination was presumptively correct; it failed to note that the Commissioner had made no record of importance. The Court of Appeals failed to note that the case had been incorrectly tried, and that, had it been correctly tried, the record and the consequences would have been entirely different.

Moreover, because the keystone of the entire penalty surtax is the burden of proof rule in Section 534 which interweaves with the entire statute through the provisions of Section 535, the Court of Appeals could not possibly attain the understanding of the intent of the amended statute as a whole, unless it addressed itself to the task of construction of Section 534. How could the Court of Ap-

peals be so certain of the Congressional intention, when it failed to ascertain that intention by analysis of the statute and study of legislative history? It would appear that a review which did not, at the very least, seek to determine whether there was or was not such interdependence of the statutory provisions, as petitioner had contended, is not the review commanded by Section 7482 of the 1954 Code, nor was it capable of a discharge of the responsibility which is inherent in the fact that the review of Tax Court decisions is exclusively entrusted by statute to the courts of appeals. (*Peurifoy* v. *Commissioner*, 358 U. S. 59 (1958))

II. Whether the Tax Court applied lawful criteria to determine the reasonableness of the business need for which petitioner had accumulated its earnings and profits.

It would appear that this question should be reviewed by this Court to correct an unlawful assumption of authority by the Tax Court to regulate the accumulation of earnings by taxpayers subject to the penalty surtax as well as to accommodate the stated intent of Congress to accomplish the elimination of the specific criteria which are applied by the Tax Court.

1. The decision by Congress to make the finding that an unreasonable amount of surplus had been accumulated determinative rather than *prima facie* evidence of intent greatly magnified the importance of that already vital question. Indeed, it made the finding conclusive, granting probative value to evidence of intent for the purpose only of rebutting the presumption.[5] Consequently, the issue of reasonable needs inevitably constitutes a most important threshold element in these controversies.

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[5] Internal Revenue Code of 1954, Section 533(a).

Over the years, the Tax Court has developed rules of thumb by which to test the reasonableness of accumulations. The most famous of these is the so-called "immediacy" test which articulates the rule that the claimed business need must bear the relationship of immediacy to *current* business needs in order to justify the accumulation of earnings in anticipation of the future cost. Inevitably, application of that rule results in a review by the Tax Court of the factors which had persuaded management to embark on the policy of retention of earnings in preparation for anticipated needs, and, in turn, in decisions which express agreement or dsiagreement with the judgment of management.

It is plainly evident that the "immediacy" rule was the standard applied in the instant case, though the Tax Court abstained from identifying it by name. Instead, the plan was called "uncertain and indefinite." Yet, the Tax Court agreed that, theoretically, a taxpayer in petitioner's position would be justified to seek to acquire the fee to premises held only by leasehold; and the Tax Court found, too, that petitioner was, in truth, seeking to acquire the premises, and also had hopes of achieving its intentions. Nevertheless, the Tax Court disagreed that the taxpayer could lawfully begin to provide for that purposes in the year under review because, in its view, the funds were not yet necessary; the certainty of accomplishment was not yet guaranteed; and the necessity for acquisition was not yet dire.

The substance of the Tax Court's objections is no more than that petitioner's officer had prematurely embarked on a policy of preparation for an expenditure which basically was without question a reasonable need of petitioner's business.

The line of demarcation between adjudication of the fact that an unreasonable accumulation has been created with

intent to prevent the imposition of tax on shareholders and the quasi-legislative process of formulation of rules regulating the time at which earnings may be accumulated without tax penalty is, nevertheless, clear in the statute. That it exists and must be preserved was inherent in the decision in *Bride* v. *Commissioner*, 22 F. 2d 39 (8th Cir. 1955), *cert. denied*, 350 U. S. 883.[6]

Certainly, it would appear that to avoid a decision which constitutes a substitution of judgment, the Tax Court must also eschew preconceived theories of what, in its opinion, constitutes reasonable business needs and, instead, seek to determine, eclectically, the course that reasonably prudent businessmen follow. The tests must remain elastic, accommodating to the particular peculiarities of the circumstances. In the final analysis, the purpose of the statute must itself impose on the adjudication process the limitation of the bona-fides of the decision of the corporation. The statute cannot be enforced in a vacuum, thoroughly insulated from the ends which Congress intended to accomplish. Since the ultimate test of the statute is that of intent, it cannot be presumed that Congress intended that an honest decision would be punishable simply because the Commissioner or the Tax Court entertained a different opinion.

2. The formulation of artificial, inelastic, and unrealistic criteria for the testing of the reasonableness of claimed business needs was condemned in the Committee Reports on the 1954 Code. It is very evident, indeed, that the inflexible application of subjectively created theories which results in the imposition of severe and unusual tax penalties actually designed to tax away a portion of the accu-

[6] The concurring decision by Judge Learned Hand in *Casey* v. *Commissioner*, 267 F. 2d 26 (2nd Cir. 1959), relied entirely on that point.

mulated profits is a matter of grave danger to small corporations and to those which require careful husbandry of resources to insure capital for growth and expansion. This tax is by its very nature discriminatory enough because it falls only on the closely-held corporation, exempting the publicly-held corporation though it may plainly be guilty of the most flagrant accumulation of earnings. In these circumstances it is no wonder that Congress was disturbed by administrative abuse which turned the statute into a penalty on small business and a threat to expanding business enterprise.

There can be no doubt that the "immediacy" test is particularly the doctrine which lends itself to administrative abuse. The Committee Reports identify it by name and the Committees specifically state their intention to eliminate it completely. In the eyes of Congress, there was too much evil in [7]

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[7] H.Rep. No. 1337, 83rd Cong., 2nd Sess. (1954) pp. 52, 53:

"(2) *Reasonable needs of the business.*—One of the principle reasons for confusion as to the application of the section 102 tax has been the lack of adequate standards as to what constitutes the reasonable needs of the business. Some of the standards informally employed in the past, such as distribution of 70 percent of earnings, have been erroneous or irrelevant. More often, in the absence of adequate guidance, revenue agents in examining cases have applied their individual concepts as to business needs.

As a result some improper criteria developed which have led to criticism of the tax on unreasonable accumulations. One such principle is the so-called immediacy test, under which there must be an immediate need for the funds in order to justify the retention of earnings. In some cases section 102 was applied even though the corporation had definite plans for expansion and the bona fides of the expansion program was not in question.

In order to eliminate the immediacy test, your committee has expressly provided in the statute that the reasonable needs of the business shall include the "reasonably anticipated" needs of the business. It is contemplated that this amendment will cover the case where the taxpayer has specific and

Particularly appropriate to the record here, is the language describing the abuse which the elimination of the test was designed to correct:

> "... In some cases Section 102 was applied even though the corporation had definite plans for expansion and the bona fides of the expansion program were not in question."

The Tax Court found as a fact that petitioner "desired to acquire ownership of the land and building ... and had hopes of reaching agreement with the owner." In the circumstances of that finding, the Tax Court's insistence on the "immediacy" test, though it was disguised by use of other language, continues the precise policy condemned by Congress. The subversion of Congressional intent, it would appear, is evident despite the adoption of the words, but not the meaning, of the Committee language.

III. Whether the Tax Court was precluded by law from determining the fact of petitioner's intentions solely on the basis of inferences found in the record without consideration of the testimony in the record which was fairly destructive of that finding.

It would appear that this question, vitally important as the criterion for proper judicial process in Tax Court proceedings, is one which this Court should answer but which it has not.

1. The Tax Court was originally established as the Board of Tax Appeals to remedy the absence of the right to a

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definite plans for acquisition of buildings or equipment in the business. It would not apply where the future plans are vague and indefinite, or where execution of the plans is postponed indefinitely."

The same language appears in S. Rep. No. 1622, 83rd Cong., 2nd Sess. (1954) p. 69.

judicial review of the Commissioner's deficiency determinations in advance of their becoming collectible. That the Tax Court review was intended as a judicial proceeding rather than an administrative hearing is evident from the elimination of the subsequent review of its findings in a federal district court.

When this Court in *Dobson* v. *Commissioner*, 321 U. S. 231 (1943) drew the cloak of accommodation to administrative expertise over the findings of the Tax Court, Congress clearly showed that such consideration for the specialized knowledge and skill of the Tax Court was not favored. Congress changed the rule of the *Dobson* decision by enactment of the provision now found in Section 7482(a) of the 1954 Code which subject the findings of the Tax Court to precisely the same degree of review as would be the condition of a decision by a district court.

Further evidence of Congressional purpose to establish the Tax Court as a court (though of limited jurisdiction) is found in Section 7453 of the 1954 Code which continues the statutory requirement established since 1926[8] that the Tax Court conduct its hearings in accordance with the rules of evidence applicable in non-jury trials in the federal district courts.

That the Tax Court is for all purposes a court of limited jurisdiction is a conclusion not weakened by reason of the statutory definition of the Tax Court as an administrative agency. That unique definition for a tribunal called a "Court" can fairly be attributed to the Congressional desire that the personnel of the Tax Court, and of those who practice before it, not be restricted to lawyers rather than to a desire to down-grade the level or status of the Court's functions.[9]

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[8] Rev. Act of 1926, section 1000.

[9] House Discussion—Vol. 88 Cong. Rec. 6335-36.

It is unquestioned that the evidentiary rule in federal courts is that of a preponderance of evidence. It is clearly impossible to determine the preponderance of evidence unless the weight of that which is contrary is also appraised. No statutory provision or other rule of law supports the Tax Court in its frequent practice not to appraise both sides of a controverted issue of fact.

2. The provisions of Section 7482 of the 1954 Code which this Court, in *Pourifoy* v. *Commissioner*, 358 U. S. 59 (1958), said entrusted the review of Tax Court decisions to the courts of appeals also imposed the "clearly erroneous" rule on that appellate review. This Court also noted that the language of the statute required that the appellate review be governed by Federal Rule 52(a). That being so, the courts of appeals would be required to reverse for failure of the Tax Court to give effect to testimony absolutely establishing a fact, particularly when such evidence has been fully corroborated and it is inherently credible and unimpeached. It is evident that a finding of fact, which must be reversed on review for lack of support in the record as a whole, cannot, logically, be proper below.

3. The most fundamental underlying question here is the relationship of the Tax Court's review to the determinations of the Commissioner, and that question is at present entirely unresolved. In the circumstances of the volume and importance of Tax Court litigation, as well as the remedial purposes voiced by the creation of that Court, it would appear that this question should be resolved.

The function of the Tax Court is to review the deficiency determinations of an administrative agency, the Internal Revenue Service. In discharging this duty, the Tax Court establishes a record, *de novo*. As this Court noted in *Universal Camera Corp.* v. *N. L. R. B.*, 340 U. S. 474, 483-484

(1951), Section 10(e) of the Administrative Procedure Act[10] expressed Congressional displeasure with the prevalent practice of reviewing courts to approve administrative adjudications if merely supported by substantial evidence in the record. This Court said that the statutory requirement that the reviewing court consider the entire record, or so much of the record as the parties cited, meant that the substantiality of evidence could not be appraised without consideration of the weight of the evidence which fairly detracted from its weight.

Thus, a review by the Tax Court which in this case resolved the controverted factual question of intent solely by reliance on presumption and inference (even though characterized as affirmative evidence) absolutely failed to satisfy the statutory standards for that review unless it also appraised the weight of the testimony that fairly rebutted those presumptions and inferences.

It would appear, therefore, that the Tax Court's method of appraisal of the record constitutes a special rule of evidence which violates governing law. The policy of applying such rule of evidence is also destructive of its value as a court of limited jurisdiction created to interpose the shield of the rule of law between taxpayers and the collection agency of the government. Even if no other statutory provision required the Tax Court to apply the rule of preponderance of evidence, Section 10(e) of the Administrative Procedure Act would prohibit findings of fact not based on appraisal of the entire record.

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[10] The Attorney General's opinion was that the Tax Court is a reviewing agency within the definition of Sec. 10(e) of the Administrative Procedure Act. (Appendix to Attorney General's Statement Regarding Revised Committee Print of October 5, 1945.)

4. This controversy also involves the question whether or not the Tax Court can refuse to make a finding of fact, established by unimpeached, uncontroverted, and inherently credible testimony in open court. In this case, petitioner's officer testified directly that his decision not to make dividend distributions was entirely motivated by his opinion that such distribution would jeopardize the plan for acquisition, and that he had reached that decision though he had been warned of the danger of the penalty statute. That testimony was fully corroborated. Nevertheless, the Tax Court found his motivation to be that of intent to prevent imposition of tax on dividend distributions.

It would appear that in this respect this question is similar to that in *Commissioner* v. *Duberstein*, Docket No. 376 in which a petition for certiorari was granted by this Court on December 14, 1959.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

MICHAEL KAMINSKY
Attorney for Petitioner
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New York 17, New York

April 1960

APPENDIX A

Statutes

INTERNAL REVENUE CODE OF 1939

SEC. 102. SURTAX ON CORPORATIONS IMPROPERLY ACCUMULATING SURPLUS.

(a) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year (in addition to other taxes imposed by this chapter) upon the net income of every corporation (other than a personal holding company as defined in section 501 or a foreign personal holding company as defined in Supplement P) if such corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting earnings or profits to accumulate instead of being divided or distributed, a surtax equal to the sum of the following:

27½ per centum of the amount of the undistributed section 102 net income not in excess of $100,000, plus 38½ per centum of the undistributed section 102 net income in excess of $100,000.

* * * * *

(c) *Evidence Determinative of Purpose.*—The fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax upon shareholders unless the corporation by the clear preponderance of the evidence shall prove to the contrary.

(d) *Definitions.*—As used in this chapter—

(1) *Section 102 net income.*—The term "section 102 net income" means the net income, computed without

the benefit of the capital loss carry-over provided in section 117 (e) from a taxable year which begins after December 31, 1940, and computed without the net operating loss deduction provided in section 23 (s), minus the sum of—

(A) Taxes.—Federal income, war-profits, and excess profits taxes (other than the tax imposed by Subchapter E of Chapter 2 for a taxable year beginning after December 31, 1940) paid or accrued during the taxable year, to the extent not allowed as a deduction by section 23, but not including the tax imposed by this section or a corresponding section of a prior income-tax law.

(B) Disallowed charitable, etc., contributions.—Contributions or gifts payment of which is made within the taxable year, not otherwise allowed as a deduction, to or for the use of donees described in section 23 (o), for the purposes therein specified. For the purposes of the preceding sentence, payment of any contribution or gift shall be considered as made within the taxable year if and only if it is considered for the purposes of section 23 (q) as made within such year.

(C) Disallowed losses.—Losses from sales or exchanges of capital assets which are disallowed as a deduction by section 117 (d).

(D) Long-term capital gains.—The excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year, minus the taxes imposed by this chapter attributable to such excess. The taxes attributable to such excess shall be an amount equal to the difference between

(i) the taxes imposed by this chapter (except the tax imposed by this section) for such year and (ii) such taxes computed for such year without including such excess in net income.

(2) *Undistributed section 102 net income.*—The term "undistributed section 102 net income" means the sec-

tion 102 net income minus the basic surtax credit provided in section 27 (b), but the computation of such credit under section 27 (b) (1) shall be made without its reduction by the amount of the credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

INTERNAL REVENUE CODE OF 1954

Corporations Improperly Accumulating Surplus

Sec. 531. Imposition of Accumulated Earnings Tax.

In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the accumulated taxable income (as defined in section 535) of every corporation described in section 532, an accumulated earnings tax equal to the sum of—

(1) 27½ percent of the accumulated taxable income not in excess of $100,000, plus

(2) 38½ percent of the accumulated taxable income in excess of $100,000.

Sec. 532. Corporations Subject to Accumulated Earnings Tax.

(a) *General Rule.*—The accumulated earnings tax imposed by section 531 shall apply to every corporation (other than those described in subsection (b)) formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed.

* * * * *

Sec. 533. Evidence of Purpose to Avoid Income Tax.

(a) *Unreasonable Accumulation Determinative of Purpose.*—For purposes of section 532, the fact that the earn-

ings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary.

* * * * * *

SEC. 534. BURDEN OF PROOF.

(a) *General Rule.*—In any proceeding before the Tax Court involving a notice of deficiency based in whole or in part on the allegation that all or any part of the earnings and profits have been permitted to accumulate beyond the reasonable needs of the business, the burden of proof with respect to such allegations shall—

(1) if notification has not been sent in accordance with subsection (b), be on the Secretary or his delegate, or

(2) if the taxpayer has submitted the statement described in subsection (c), be on the Secretary or his delegate with respect to the grounds set forth in such statement in accordance with the provisions of such subsection.

(b) *Notification by Secretary.* [As amended by Sec. 5 of Public Law 367, 69 Stat. 689]—Before mailing the notice of deficiency referred to in subsection (a), the Secretary or his delegate may send by registered mail a notification informing the taxpayer that the proposed notice of deficiency includes an amount with respect to the accumulated earnings tax imposed by section 531. In the case of a notice of deficiency to which subsection (c) (2) applies and which is mailed on or before the 30th day after the date of the enactment of this sentence, the notification referred to in the preceding sentence may be mailed at any time on or before such 30th day.

(c) *Statment by Taxpayer.*—Within such time (but not less than 30 days) after the mailing of the notification described in subsection (b) as the Secretary or his delegate may prescribe by regulations, the taxpayer may submit a statement of the grounds (together with facts sufficient to show the basis thereof) on which the taxpayer relies to establish that all or any part of the earnings and profits have not been permitted to accumulate beyond the reasonable needs of the business.

(d) *Jeopardy Assessment.*—If pursuant to section 6861 (a) a jeopardy assessment is made before the mailing of the notice of deficiency referred to in subsection (a), for purposes of this section such notice of deficiency shall, to the extent that informs the taxpayer that such deficiency includes the accumulated earnings tax imposed by section 531, constitute the notification described in subsection (b), and in that event the statement described in subsection (c) may be included in the taxpayer's petition to the Tax Court.

(e) *Application of Section.*—[As amended by Sec. 4 of Public Law 367, 69 Stat. 689]

(1) Notwithstanding any other provision of law, this section shall apply with respect to taxable years to which this subchapter applies and (except as provided in paragraph (2)) to taxable years to which the corresponding provisions of prior revenue laws apply.

(2) In the case of a notice of deficiency for a taxable year to which this subchapter does not apply, this section shall apply only in the case of proceedings tried on the merits after the date of the enactment of this paragraph.

SEC. 535. ACCUMULATED TAXABLE INCOME.

(a) *Definition.*—For purposes of this subtitle, the term "accumulated taxable income" means the taxable income, adjusted in the manner provided in subsection (b), minus

the sum of the dividends paid deduction (as defined in section 561) and the accumulated earnings credit (as defined in subsection (c)).

(b) *Adjustments to Taxable Income.*—For purposes of subsection (a), taxable income shall be adjusted as follows:

(1) *Taxes.*—There shall be allowed as a deduction Federal income and excess profits taxes (other than the excess profits tax imposed by subchapter E of chapter 2 of the Internal Revenue Code of 1939 for taxable years beginning after December 31, 1940) and income, war profits, and excess profits taxes of foreign countries and possessions of the United States (to the extent not allowable as a deduction under section 164 (b) (6)), accrued during the taxable year, but not including the accumulated earnings tax imposed by section 531, the personal holding company tax imposed by section 541, or the taxes imposed by corresponding sections of a prior income tax law.

(2) *Charitable contributions.*—The deduction for charitable contributions provided under section 170 shall be allowed without regard to the limitation in section 170 (b) (2).

(3) *Special deductions disallowed.*—The special deductions for corporations provided in part VIII (except section 248) of subchapter B (section 241 and following, relating to the deduction for dividends received by corporations, etc.) shall not be allowed.

(4) *Net operating loss.*—The net operating loss deduction provided in section 172 shall not be allowed.

(5) *Capital losses.*—There shall be allowed as deductions losses from sales or exchanges of capital assets during the taxable year which are disallowed as deductions under section 1211 (a).

(6) *Long-term capital gains.*—There shall be allowed as a deduction the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year (determined without regard to

the capital loss carryover provided in section 1212) minus the taxes imposed by this subtitle attributable to such excess. The taxes attributable to such excess shall be an amount equal to the difference between—

(A) the taxes imposed by this subtitle (except the tax imposed by this part) for such year, and

(B) such taxes computed for such year without including such excess in taaxble income.

(7) *Capital loss carryover.*—No allowance shall be made for the capital loss carryover provided in section 1212.

(8) *Bank affiliates.*—There shall be allowed the deduction described in section 601 (relating to bank affiliates).

(c) *Accumulated Earnings Credit.*—

(1) *General rule.*—For purposes of subsection (a), in the case of a corporation other than a mere holding or investment company the accumulated earnings credit is (A) an amount equal to such part of the earnings and profits for the taxable year as are retained for the reasonable needs of the business, minus (B) the deduction allowed by subsection (b) (6). For purposes of this paragraph, the amount of the earnings and profits for the taxable year which are retained is the amount by which the earnings and profits for the taxable year exceed the dividends paid deduction (as defined in section 561) for such year.

(2) *Minimum credit.*—The credit allowable under paragraph (1) shall in no case be less than the amount by which $60,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year.

(3) *Holding and investment companies.*—In the case of a corporation which is a mere holding or investment company, the accumulated earnings credit is the amount (if any) by which $60,000 exceeds the accumulated

earnings and profits of the corporation at the close of the preceding taxable year.

(4) *Accumulated earnings and profits.*—For purposes of paragraphs (2) and (3), the accumulated earnings and profits at the close of the preceding taxable year shall be reduced by the dividends which under section 563 (a) (relating to dividends paid after the close of the taxable year) are considered as paid during such taxable year.

SEC. 7453. RULES OF PRACTICE, PROCEDURE, AND EVIDENCE.

The proceedings of the Tax Court and its divisions shall be conducted in accordance with such rules of practice and procedure (other than rules of evidence) as the Tax Court may prescribe and in accordance with the rules of evidence applicable in trials without a jury in the United States District Court of the District of Columbia.

* * * * *

SEC. 7482. COURTS OF REVIEW.

(a) *Jurisdiction.*—The United States Courts of Appeals shall have exclusive jurisdiction to review the decisions of the Tax Court, except as provided in section 1254 of Title 28 of the United States Code, in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury; and the judgment of any such court shall be final, except that it shall be subject to review by the Supreme Court of the United States upon certiorari, in the manner provided in section 1254 of Title 28 of the United States Code.

APPENDIX B

Opinion

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 94—October Term, 1959.

(Argued December 9, 1959 Decided January 11, 1960.)

Docket No. 25762

I. A. DRESS CO., INC.,

Petitioner,

—v.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Before:

LUMBARD, *Chief Judge,*
SWAN and FRIENDLY, *Circuit Judges.*

Petition to review a decision of the Tax Court of the United States, Withey, *Judge*, reported at 32 T. C. 93.

MICHAEL KAMINSKY, *Attorney for Petitioner,*
Leo Kotler, of Counsel.

CHARLES K. RICE, Assistant Attorney General, Lee A. Jackson, Melva M. Graney and Melvin L. Lebow, Attorneys, Department of Justice, Washington 25, D. C., *for Respondent.*

SWAN, *Circuit Judge*:

The Tax Court sustained the Commissioner's determination of an income tax deficiency in petitioner's surtax for the taxable year 1949 computed under section 102 of the 1939 Code (26 U. S. C. 1952 ed., Sec. 102). Section 102(a) imposes a surtax upon the net income of a corporation, if such corporation is availed of for the purpose of preventing the imposition of surtax upon its shareholders "through the medium of permitting earnings or profits to accumulate instead of being divided or distributed." Section 102(c) provides:

> "*Evidence determinative of purpose.*—The fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax upon shareholders unless the corporation by the clear preponderance of the evidence shall prove to the contrary."

After reviewing the evidence the Tax Court stated: "Consequently, we conclude from an examination of the record herein that petitioner in 1949 had accumulated its earning and profits beyond its reasonable business needs." The opinion then refers to section 102(c) and continues: "The petitioner has failed to establish by a clear preponderance of the evidence that it was not availed of for the purpose of preventing the imposition of income tax upon the sole stockholder, Isaac Alper. In fact, the record contains affirmative evidence that petitioner *was* availed of for such a purpose."

The taxpayer was organized in 1924 with a paid-in capital of $5,000. In 1927 it leased a building in New York City. Its business has consisted in subletting space in this building, collecting rents and furnishing all the services required

of a landlord. The lease under which it occupied the building in 1949 ran to January 31, 1964. In 1950, the parties agreed to extend the lease to January 31, 1967. Its business has prospered. In 1949 its accumulated earnings and profits were $106,821.06. It has never paid a dividend.[1] The alleged reason for accumulation of earnings and profits during all these years is that the taxpayer plans to buy the fee of the building it leases. But it has no option to buy, and in 1949 it had no reason to know whether or when it could come to terms with the owner, who was willing to sell but at a price some $300,000 more than the taxpayer was willing to pay. It expects that part of the purchase price will be provided by a mortgage, but no evidence was presented as to the amount of the mortgage or as to expected earnings before the purchase might eventually be made at some indefinite future date. If such a vague plan were sufficient to avoid the corporate surtax, any individual could organize a one-man corporation, lease a building and discuss with the lessor the purchase of the building at some future time, and then assert that in the meantime business needs required accumulation of corporate earnings. Congress could never have intended Section 102 to be so easily evaded.

Additional facts supporting the Tax Court's conclusions appear in its findings and opinion, and need not be restated here. Its findings of fact cannot be set aside by a reviewing court "unless clearly erroneous."[2] We think them amply supported by the evidence.

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[1] The item of $9,000 shown as a dividend paid in 1947 represents a surplus adjustment for a prior year.

[2] *Casey* v. *Commissioner of Int. Rev.*, 2 Cir., 267 F. 2d 26, 31; *Trico Products Corporation* v. *McGowan*, 2 Cir., 169 F. 2d 343, 344, cert. denied 335 U. S. 899; *Latchis Theatres of Keene* v. *Commissioner of Int. Rev.*, 1 Cir., 214 F. 2d 834, 835.

Relying upon Section 534 of the 1954 Code (26 U. S. C. 1958 ed., Sec. 534), which, on certain conditions transfers to the respondent the burden of proof, the taxpayer contends that the Tax Court erred in holding that the requirements of that section had not been met. We think it unnecessary to pass upon that question at the present time. On the record before us the Tax Court's findings are supportable regardless of which party had the burden of proof.

Decision affirmed.

Judgment

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the eleventh day of January one thousand nine hundred and sixty.

Present:

HON. J. EDWARD LUMBARD,
Chief Judge,

HON. THOMAS W. SWAN,
HON. HENRY J. FRIENDLY,
Circuit Judges.

I. A. DRESS CO. INC.,
Petitioner,

—v.—

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Appeals from The Tax Court of the United States

This cause came on to be heard on the transcript of record from The Tax Court of the United States, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the order of said The Tax Court of the United States be and it hereby is affirmed.

A. DANIEL FUSARO
Clerk